

## Message Text

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ACTION ARA-14

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03  
INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03  
SP-02 LAB-04 SIL-01 OMB-01 MMO-01 IGA-02 AGRE-00  
STR-04 ITC-01 /065 W  
-----053069 161449Z /43

P R 161230Z AUG 77  
FM AMEMBASSY BRASILIA  
TO SECSTATE WASHDC PRIORITY 3261  
INFO AMCONSUL RIO DE JANEIRO  
AMCONSUL SAO PAULO  
AMEMBASSY ASUNCION  
AMEMBASSY BUENOS AIRES  
AMEMBASSY MONTEVIDEO  
AMEMBASSY SANTIAGO

C O N F I D E N T I A L SECTION 1 OF 3 BRASILIA 6785

E.O. 11652: GDS  
TAGS: ECON, BR  
SUBJ: ECONOMIC ALERT REPORT

REF: STATE 180067

1. SUMMARY: THE BRAZILIAN GOVERNMENT FACES TWO PRINCIPAL ECONOMIC PROBLEMS--INFLATION AND A SUBSTANTIAL CURRENT ACCOUNT DEFICIT. THE GOB HAS IMPLEMENTED A SERIES OF POLICIES INCLUDING IMPORT RESTRICTIONS AND EXPORT INCENTIVES TO RESTORE BALANCE TO BRAZIL'S EXTERNAL ACCOUNTS AND IS CURRENTLY IMPLEMENTING GRADUALIST MEASURES TO REDUCE THE INFLATION RATE. THESE ACTIONS HAVE BEGUN TO SHOW RESULTS, BUT A NUMBER OF THESE MEASURES (PARTICULARLY IMPORT AND EXPORT POLICIES) HAVE BEEN AT ODDS WITH U.S. COMMERCIAL INTERESTS. IN ADDITION, THE STEPS TAKEN BY THE GOB TO SLOW ECONOMIC GROWTH AND REDUCE THE INFLATION RATE MAY AMPLIFY RECENT TRENDS TOWARD GREATER ECONOMIC NATIONALISM. ALTHOUGH SEVERAL BILATERAL PROBLEMS HAVE BEEN RESOLVED, THERE REMAIN SECONDARY ECONOMIC-COMMERCIAL  
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ISSUES WHICH ARE POTENTIAL FLASH POINTS DURING THE COMING YEAR.

A. MAJOR ECONOMIC PROBLEMS

2. BRAZIL'S TWO PRINCIPAL ECONOMIC PROBLEMS ARE  
THE HIGH RATE OF INFLATION AND, SECONDARILY,

A SUBSTANTIAL CURRENT ACCOUNT DEFICIT. OVERALL, HOWEVER, THE EXTERNAL PAYMENTS POSITION, IS STRONG WHILE GRADUAL PROGRESS IS BEING MADE IN CURTAILING THE INCREASE IN PRICES. THE TRADE ACCOUNT WILL BE IN BALANCE THIS YEAR BUT GROSS EXTERNAL FINANCING REQUIREMENTS, WHILE REDUCED, REMAIN SUBSTANTIAL (DOLS 7.0 BILLION) BRAZIL'S EXTERNAL DEBT, PUBLIC AND PRIVATE, STOOD AT ABOUT DOLS 27 BILLION IN JANUARY AND IS EXPECTED TO EXCEED DOLS 30 BILLION BY YEAR-END (MEDIUM AND LONG DEBT ONLY), SOME 40 PER CENT OF WHICH REPRESENTS LOANS FROM US BANKS (DOLS 12 BILLION). SERVICING THIS DEBT, BOTH INTEREST AND AMORTIZATION, REPRESENT A SUBSTANTIAL CHARGE AGAINST BRAZIL'S EXTERNAL ACCOUNTS (OVER DOLS 5 BILLION IN 1977, COMPARED TO PROJECTED EXPORT EARNINGS OF DOLS 12-13 BILLION). BRAZIL'S INTERNATIONAL CREDIT RATING, HOWEVER, REMAINS HIGH, AND THE COUNTRY THUS IS NOT EXPECTED TO ENCOUNTER ANY DIFFICULTIES RAISING THE EXTERNAL FINANCING REQUIRED OVER THE NEXT SEVERAL YEARS. POINTS OF LONG-TERM VULNERABILITY, OF COURSE, ARE THE LARGE DEPENDENCE ON IMPORTED OIL (SOME 80 PERCENT OF DOMESTIC CONSUMPTION, CONSTITUTING ONE-THIRD OF TOTAL IMPORTS), AND WORLD MARKET TRENDS IN PRIMARY COMMODITIES (I.E., COFFEE, SOYBEANS, IRON ORE, SUGAR, AND COCOA). ALSO IMPORTANT IS THE DEPENDENCE OF BRAZIL'S EXPORT DIVERSIFICATION STRATEGY (I.E. PROMOTION OF

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MANUFACTURED GOODS NOW REPRESENTING ONE-THIRD OF TOTAL EXPORTS) ON LIBERAL TRADE POLICIES OF THE PRINCIPAL INDUSTRIAL COUNTRIES. TO REDUCE FURTHER THE GROWTH OF ITS EXTERNAL DEBT, BRAZIL MUST ESTABLISH A SIGNIFICANT TRADE SURPLUS. CONCERN OVER THE GROWTH OF ITS INDEBTEDNESS, ALONG WITH THE HEAVY EMPHASIS ON IMPORT SUBSTITUTION UNDER THE CURRENT DEVELOPMENT STRATEGY, ENSURE THAT BRAZIL WILL MAINTAIN ITS POLICIES OF SEVERE IMPORT RESTRAINT AND SPECIAL EXPORT INCENTIVES -- POLICIES WHICH ARE IN CONFLICT WITH US COMMERCIAL INTERESTS AND COMMITMENTS UNDER THE GATT.

3. THE GOB'S HIGHEST ECONOMIC PRIORITY FOR THE NEAR TERM, IS THE CONTROL OF INFLATION, WHICH REACHED 46 PERCENT IN 1976, THE HIGHEST RATE IN THE LAST TWELVE YEARS. THE GOB'S POLICIES -- A PROGRESSIVE TIGHTENING OF CREDIT RESTRICTIONS, CUTS IN PUBLIC SECTOR INVESTMENT BUDGETS, REDUCED WAGE SALARY INCREASES, AND SMALLER INCREASES IN CONTROLLED PRICES -- HAVE PRODUCED SOME RESULTS (INFLATION RATE REDUCED TO 40 PERCENT IN MID-YEAR 1977). POLITICAL PRESSURES FROM SPECIAL INTERESTS FOR

EXCEPTIONS FROM THE POLICY WILL MOUNT, HOWEVER, OVER TIME.  
OVER-ALL, THE OUTLOOK IS GOOD FOR A GRADUAL REDUCTION OF  
INFLATION -- AN ESSENTIAL CONDITION FOR THE  
MAINTENANCE OF INTERNATIONAL CONFIDENCE IN BRAZIL'S  
ECONOMIC MANAGEMENT.

4. THE GOB'S ANTI-INFLATION POLICY, WITH ITS PROSPECT OF  
CUTTING THIS YEAR'S ECONOMIC GROWTH NEARLY BY HALF (8.8 PERCENT  
IN 1976), HAS PRODUCED A STRONGLY NATIONALISTIC REACTION  
FROM BRAZIL'S PRIVATELY-OWNED INDUSTRIAL SECTOR, ESPECIALLY THE  
HEAVY, ELECTRICAL, AND MECHANICAL INDUSTRIES CONCENTRATED IN  
SAO PAULO STATE. THE MANAGEMENT OF THESE INDUSTRIES, WHICH  
HAVE GREATLY INCREASED THEIR CAPACITY IN RECENT

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YEARS, IS FEARFUL OF THE EFFECTS OF THE ECONOMIC SLOWDOWN ON  
THEIR HIGHLY-LEVERAGED BALANCE SHEETS. IN ADDITION TO THE  
LONG-STANDING EXCLUSION OF CONSUMER GOODS IMPORTS, BRAZILIAN  
MANUFACTURERS HAVE RECENTLY SUCCEEDED IN FURTHER LIMITING  
COMPETITION FROM IMPORTED CAPITAL GOODS, SUCH AS BY  
INSISTING ON PROGRESSIVELY MORE SEVERE REQUIREMENTS  
WITH RESPECT TO THE SHARE OF DOMESTICALLY PRODUCED  
EQUIPMENT IN PUBLIC SECTOR INVESTMENTS AND IN CAPITAL PROJECTS  
INVOLVING GOVERNMENT FINANCING OR BENEFITS. THE POWERFUL  
INDUSTRY FEDERATIONS ALSO ARE TAKING AN INCREASINGLY OUTSPOKEN  
STANCE AGAINST NEW FOREIGN INVESTMENTS, WHERE THESE THREATEN

INCREASED COMPETITION TO NATIONAL FIRMS, SUCH AS IN THE RECENT MASSIVE CAMPAIGN OF PUBLIC CRITICISM AGAINST THE GOVERNMENT'S DECISION PERMITTING THREE NON-US (GERMAN AND JAPANESE) MULTINATIONALS TO GO FORWARD WITH MAJOR NEW CAPITAL PROJECTS IN MINAS GERAIS. THE GOVERNMENT GENERALLY IS STANDING ITS GROUND IN PRINCIPLE ON THE IMPORTANCE OF FOREIGN INVESTMENT, ESPECIALLY IN LESS DEVELOPED INDUSTRIAL SECTORS. THE AUTHORITIES, CONFIDENTIAL

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HOWEVER, WILL CONTINUE TO MAKE CONCESSIONS TO DOMESTIC INTERESTS, WHICH ADVERSELY AFFECT THE CLIMATE FOR FOREIGN INVESTMENT, AS WAS THE CASE WITH THE RECENTLY IMPOSED LIMITATION ON OFFICIAL FINANCING FOR CAPITAL GOODS PRODUCED BY WHOLLY-OWNED BRAZILIAN SUBSIDIARIES OF FOREIGN FIRMS. DESPITE THESE POLICIES, BRAZIL REMAINS AN ATTRACTIVE PLACE FOR FOREIGN INVESTORS (NET DIRECT CAPITAL INFLOW OF DOLS 1 BILLION PER ANNUM), AND THE US, OF COURSE, MAINTAINS ITS POSITION AS THE LEADING FOREIGN INVESTOR (BOOD VALUE OF DOLS 4.5 BILLION AT END 75).

5. US ECONOMIC INTERESTS -- AND, INDEED, THE US LONG-TERM POSITION HERE -- ARE ADVERSELY AFFECTED BY A CONSCIOUS GOB STRATEGY OF DIVERSIFYING ITS ECONOMIC RELATIONSHIPS AWAY FROM THE US, THUS REDUCING BRAZIL'S ECONOMIC AND POLITICAL DEPENDENCE ON THE UNITED STATES. THIS BRAZILIAN POLICY OF DIVERSIFYING TRADE AND INVESTMENT TIES IS THE RESULT OF MANY FACTORS, INCLUDING BRAZILIAN CONCERN OVER ITS SUBSTANTIAL BILATERAL TRADE DEFICIT, THE SEARCH FOR NEW EXPORT MARKETS, THE STRONG INTEREST OF EUROPEAN (ESPECIALLY GERMAN) AND JAPANESE MULTINATIONALS IN BRAZIL FORCEFULLY SUPPORTED BY THEIR HOME GOVERNMENTS, IRRITATION OVER BILATERAL ECONOMIC ISSUES (SUCH AS THE COUNTERVAILING DUTY PROVISIONS OF THE US TRADE LAW), AND -- MORE GENERALLY -- BRAZIL'S POSTURE OF PRAGMATIC ECUMENICISM," INCLUDING THE EFFECT ON BRAZILIAN ATTITUDES OF POLICY DIFFERENCES BETWEEN WASHINGTON AND BRASILIA SUCH AS THE FRG/GOB NUCLEAR ACCORD AND HUMAN RIGHTS. ALTHOUGH THERE IS NO FIRM EVIDENCE THAT A GENERAL POLICY OF DISCRIMINATION AGAINST US FIRMS IS BEING SYSTEMATICALLY IMPLEMENTED, BRAZIL HAS SUBTLE POLICY TOOLS AT ITS DISPOSAL TO PRACTICE DISCRIMINATION IF IT WISHES. THE CURRENT CLIMATE OF STRONG COMPETITION AMONG US, EUROPEAN, CONFIDENTIAL

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AND JAPANESE INTERESTS OVER INVESTMENT PROJECTS ALLOWS THE GOB TO GIVE PREFERENCES TO NON-US FIRMS. IN ADDITION, THE IMPORTANCE

OF LARGE STATE CORPORATIONS IN THE ECONOMY PROVIDES THE OPPORTUNITY TO DIRECT IMPORTS AWAY FROM THE US THROUGH ADMINISTRATIVE ACTIONS. HAVING SAID THIS, LARGE PARTS OF THE BRAZILIAN ESTABLISHMENT, ESPECIAL-  
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-LLY THE LEADERSHIP OF THE ECONOMIC MINISTRIES, RECOGNIZE THE CONTINUED IMPORTANCE OF THE US FOR BRAZIL'S DRIVE TO MATURE INDUSTRIAL POWER STATUS --AS AN EXPORT MARKET AS WELL AS SOURCE OF CAPITAL AND TECHNOLOGY--AND EXERT, WE BELIEVE, A MODERATING INFLUENCE ON THESE TRENDS IN BRAZILIAN POLICY DELETERIOUS TO US ECONOMIC (AND, ULTIMATELY, POLITICAL) INTERESTS.

B. OUTLOOK FOR THE NEXT TWELVE MONTHS

6..ECONOMIC RELATIONS ARE EXPECTED TO REMAIN FREE OF MAJOR FRICTION. THE BILATERAL TRADE DEFICIT, A MAJOR IRRITATION TO BRAZILIAN OFFICIALS IN THE PAST, HAS DISAPPEARED THIS YEAR, PARTLY AS A RESULT OF HIGH COFFEE PRICES. THE PRESIDENT'S DECISIONS ON SHOES AND SUGAR, ALTHOUGH BASED ON GLOBAL CONSIDERATIONS, HAD THE IMPORTANT SIDE BENEFIT OF FORESTALLING MAJOR TRADE PROBLEMS WITH BRAZIL. IMPLEMENTATION OF THE SIMON-SIMONSEN AGREEMENT ON THE PHASE-OUT OF CERTAIN EXPORT INCENTIVES (I.E. FOR SHOES AND SOYBEAN OIL) IS PROCEEDING ON SCHEDULE. BRAZILIAN SHOE EXPORTS ARE DOWN AS A RESULT OF MARKET FORCES. NO NEW COMPLAINT ACTIONS BY US PRODUCERS WHICH WOULD OFFSET AFFECT BRAZIL ARE CURRENTLY UNDER WAY. AND, MORE IMPORTANT, US BANKS ARE MAINTAINING THEIR POSITIVE ATTITUDE ON LENDING TO BRAZIL. (THE EMBASSY'S ASSESSMENT OF NEAR-TERM ECONOMIC TRENDS IS CONTAINED IN A-95 OF JULY, 1977, AND IN RECENT TELEGRAPHIC MESSAGES, AND SUCH AS BRASILIA'S  
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6705 AND 5588).

7. AN IMPORTANT QUALIFICATION TO THIS FAVORABLE ASSESSMENT IS  
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THAT BRAZIL MISSED THE OPPORTUNITY TO MARKET ITS SOYBEAN CROP AT HIGH PRICES EARLIER IN THE YEAR, AND NOW WILL HAVE TO SELL REMAINING STOCKS WHILE THE BIG US CROP ENTERS THE WORLD MARKET. BRAZILIAN MANIPULATIONS ON THE WORLD COFFEE

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SP-02 LAB-04 SIL-01 OMB-01 MMO-01 IGA-02 AGRE-00  
STR-04 ITC-01 /065 W

-----052945 161448Z /43

P R 161230Z AUG 77  
FM AMEMBASSY BRASILIA  
TO SECSTATE WASHDC PRIORITY 3263  
INFO AMCONSUL RIO DE JANEIRO  
AMCONSUL SAO PAULO  
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MARKET COULD BECOME ANOTHER IRRITANT. IN THE MULTILATERAL AREA, BRAZIL WILL CONTINUE ON AN INDEPENDENT COURSE, NOT ALWAYS SATISFACTORY TO US INTERESTS AND POLICIES. IN THE MTN AREA, THERE ARE PERSISTENT REPORTS THAT BRAZIL HAS DECIDED TO WITHHOLD ITS FULL PARTICIPATION AT LEAST FROM THE WORK OF THE TARIFF GROUP. ON THE OTHER HAND, IN THE NEGOTIATIONS FOR A NEW INTERNATIONAL SUGAR AGREEMENT, A RECONCILIATION OF US AND BRAZILIAN DIFFERENCES APPEARS UNDER WAY. EQUALLY IMPORTANT, BRAZIL APPEARS TO FACE A LENGTHENING LIST OF TRADE PROBLEMS WITH THE EUROPEAN COMMUNITY WHILE THERE ARE INCREASINGLY FREQUENT REPORTS THAT TECHNICAL LEVEL OFFICIALS IN NUCLEBRAS ARE DISENCHANTED WITH GERMAN HEAVY-HANDEDNESS IN THE EXECUTION OF THE GERMAN-BRAZILIAN NUCLEAR AGREEMENT. THESE SIGNS OF BRAZILIAN IRRITATION ARE RECIPROCATED BY SOME OF BRAZIL'S MAJOR PARTNERS. JAPANESE EMBASSY SOURCES HAVE ADMITTED FRUSTRATION OVER BRAZILIAN TARDINESS AND INEFFICIENCIES IN THE IMPLEMENTATION OF MAJOR COOPERATIVE PROJECTS, SUCH AS THE CERRADO AGRICULTURAL DEVELOPMENT PROJECT IN MINAS GERAIS.

8. THE CENTRAL CRITICAL ISSUE THEREFORE WHICH COULD CAST A LONG  
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SHADOW OVER US-BRAZILIAN RELATIONS, IS OUTSIDE THE STRICTLY ECONOMIC AREA, I.E. THE FUELING OF THE WESTINGHOUSE POWER REACTOR, ANGRA I, NOW NEARING COMPLETION. TO MEET THE 1978 (ALREADY DELAYED) START-UP DATE. BRAZIL EXPECTS AN EXPORT LICENSE FOR THE FUEL RODS (TO BE MANUFACTURED FROM URANIUM ORIGINALLY PURCHASED IN SOUTH AFRICA) BY OCTOBER-NOVEMBER.

C. CRITICAL POINTS

9. IN SUMMARY, ASSUMING SOME MAJOR PROBLEMS (SHOES AND SUGAR, FOR EXAMPLE) ARE AT OR NEAR RESOLUTION AND ASSUMING FAITHFUL IMPLEMENTATION BY BRAZIL OF THE SIMON-SIMONSEN AGREEMENT, THE FOLLOWING ARE IMPORTANT POTENTIAL POINTS OF FRICTION IN THE ECONOMIC AND FUNCTIONAL AREA.

(1) THE FUELING OF ANGRA I.

(2) BRAZILIAN PURCHASES OF COFFEE ON THE NEW YORK MARKET AND BRAZILIAN CHARGES THAT THE USG IS ATTEMPTING TO MANIPULATE THE MARKET THROUGH CHANGES IN EXCHANGE REGULATIONS. THE ONGOING CFTC INVESTIGATION OF POSSIBLE IRREGULARITIES IN THE TRADING ON THE SEPTEMBER C CONTRACT MAY BRING THIS CONFLICT TO A HEAD.

(3) THE NEW TRADE CENTER IN SAO PAULO, IF THE GOB CAME TO BELIEVE THAT THE US IS NOT FULLY RECIPROCATING DUTY FREE EXHIBITION RIGHTS.

(4) MORE GENERALLY, AS ILLUSTRATED BY THE CASE OF CESSNA AIRCRAFT, THE IMPORT SUBSTITUTION PROGRAMS, WHICH ENCOURAGE LOCAL MANUFACTURING OF PREVIOUSLY IMPORTED PRODUCTS, COULD RESULT IN THE EXCLUSION OF AMERICAN FIRMS FROM LUCRATIVE MARKETS. FOR EXAMPLE, THE CURRENT SELECTION PROCESS FOR UP TO TWO MINI-COMPUTER VENTURES WILL LEAVE NUMEROUS FIRMS "OUT IN THE COLD".

(5) CONCEIVABLY, THE CURRENT DISPUTE OVER THE AIR WORTHINESS CERTIFICATION OF THE BANDEIRANTE ELEVEN PASSENGER MODEL, WHICH --  
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QUITE WORONGLY--IS PERCEIVED IN SOME BRAZILIAN AIR CIRCLES TO HAVE POLITICAL OVERTONES.

10. IN ADDITION TO THESE SPECIFIC POTENTIAL POINTS OF FRICTION, AMERICAN COMMERCE WILL CONTINUE TO FACE THE COMPLICATED ARRAY OF IMPORT RESTRAINTS ERECTED SINCE 1974 WHICH WILL CONTINUE TO CAUSE PROBLEMS AS SOME US SUPPLIERS WILL LOSE TRADITIONAL POSITIONS IN THE BRAZILIAN MARKET. BUT THE COMPLEX ADMINISTRATIVE CONTROLS, WHICH OFTEN REQUIRE JUDGMENTS ON THE PART OF INDIVIDUAL BRAZILIAN BUREAUCRATS, WILL MAKE IT DIFFICULT, IF NOT IMPOSSIBLE, TO PROVE THE EFFECTS OF SUCH RESTRAINTS IN INDIVIDUAL CASES. RUSER

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## Message Attributes

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**Capture Date:** 01-Jan-1994 12:00:00 am  
**Channel Indicators:** n/a  
**Current Classification:** UNCLASSIFIED  
**Concepts:** ECONOMIC REPORTS, ECONOMIC TRENDS  
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**Copy:** SINGLE  
**Sent Date:** 16-Aug-1977 12:00:00 am  
**Decaption Date:** 01-Jan-1960 12:00:00 am  
**Decaption Note:**  
**Disposition Action:** RELEASED  
**Disposition Approved on Date:**  
**Disposition Case Number:** n/a  
**Disposition Comment:** 25 YEAR REVIEW  
**Disposition Date:** 22 May 2009  
**Disposition Event:**  
**Disposition History:** n/a  
**Disposition Reason:**  
**Disposition Remarks:**  
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**Document Source:** CORE  
**Document Unique ID:** 00  
**Drafter:** n/a  
**Enclosure:** n/a  
**Executive Order:** GS  
**Errors:** N/A  
**Expiration:**  
**Film Number:** D770295-0286  
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**Original Classification:** CONFIDENTIAL  
**Original Handling Restrictions:** n/a  
**Original Previous Classification:** n/a  
**Original Previous Handling Restrictions:** n/a  
**Page Count:** 7  
**Previous Channel Indicators:** n/a  
**Previous Classification:** CONFIDENTIAL  
**Previous Handling Restrictions:** n/a  
**Reference:** 77 STATE 180067  
**Retention:** 0  
**Review Action:** RELEASED, APPROVED  
**Review Content Flags:**  
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**Review Event:**  
**Review Exemptions:** n/a  
**Review Media Identifier:**  
**Review Release Date:** n/a  
**Review Release Event:** n/a  
**Review Transfer Date:**  
**Review Withdrawn Fields:** n/a  
**SAS ID:** 1593821  
**Secure:** OPEN  
**Status:** NATIVE  
**Subject:** ECONOMIC ALERT REPORT  
**TAGS:** ECON, BR  
**To:** STATE  
**Type:** TE  
**vdkgvwkey:** odbc://SAS/SAS.dbo.SAS\_Docs/130c635a-c288-dd11-92da-001cc4696bcc  
**Review Markings:**  
Margaret P. Grafeld  
Declassified/Released  
US Department of State  
EO Systematic Review  
22 May 2009  
**Markings:** Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 22 May 2009